Office of Chief Counsel
Internal Revenue Service

memorandum

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JPJankowski

date: April 16, 2002

to: LMSB Group [redacted]
Attn: [redacted], LMSB Team Manager

from: Area Counsel
(Retailers, Food, Pharmaceuticals)

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subject: **[redacted], et al**
Request for Legal Advice and Assistance

The purpose of this memorandum is to respond to Team Leader [redacted]'s request for assistance in a matter arising from your examination of the above-noted LMSB, Large Case taxpayer. We understand that your examination includes the tax periods ending [redacted], [redacted] and a short period ending [redacted].

The assistance provided by the undersigned is in accordance with the former Large Case Coordination Procedures, for all significant advice provided in non-docketed LMSB (CEP) large cases. **In accordance with the April 2, 2001 Office of Chief Counsel directive, regarding standardized disclosure statements, <u>you are hereby advised that this memorandum should not be cited as precedent</u>.**

In reviewing your request for assistance, the undersigned contacted the Associate Area Counsel, Industry Programs (IP) for HMT and RFP. It was determined and agreed that the question posed by you did not rise to the level of an "Industry Issue", requiring formal industry coordination. Rather, it is a fact question, resulting in a proposed timing adjustment between fiscal tax periods. Since your request is deemed a routine administrative matter, it required no formal coordination with the National Office or the HMT Associate Area Counsel (IP).

In accordance with the former Large Case (LMSB) coordination procedures, this written legal advisory is being treated as a non-significant advice request (NSAR). We previously submitted our April 2, 2002 advisory memorandum opinion for post review and recently received a response from the National Office. This revised memorandum, incorporating all recommended changes, supercedes our original NSAR 10-day post review memorandum dated April 2, 2002.

Issue Presented:

In what tax year should "Yield-Maintenance Premiums" arising from the taxpayer's early termination and payoff of three notes be accrued and deducted?

Brief Answer:

The Yield-Maintenance Premiums (hereinafter identified as prepayment premiums) are not deductible by [redacted] in the short tax year ended [redacted]. The prepayment premiums should be deductible in the tax year when they are fully paid. Although the taxpayer provided official notice of its intent to prepay the underlying notes during the tax year ended [redacted], taxpayer did not actually pay the prepayment premiums until the following tax period. Therefore, the prepayment premiums are deductible in the following tax period, when the prepayment premiums were actually paid.

Facts

On or about [redacted], [redacted], a Delaware corporation, entered into a formal Agreement and Plan of Merger (hereinafter the "Merger Agreement"). The third party participants involved with the Merger Agreement are [redacted] and [redacted]. [redacted] (hereinafter [redacted]) is also a Delaware corporation.

[redacted] (hereinafter "[redacted]") was incorporated on or about [redacted], as a direct subsidiary of [redacted] and is also a Delaware corporation. [redacted] (EIN: [redacted]) was formed solely for the purpose of engaging in the merger transaction contemplated in the Merger Agreement. It had no other business activities prior to the consummation of the merger with [redacted].

The Merger Agreement, as contemplated by the parties, planned for [redacted] and [redacted] to acquire [redacted] in a reorganization under the authority of I.R.C. Section 368(a). In order to effectuate the merger, as noted above, [redacted] used [redacted] as the merger vehicle. At the "Effective Time", ([redacted] p.m. on [redacted]) under Delaware law, [redacted] exchanged [redacted] shares of its common stock and cash of $[redacted] for each of the outstanding shares of [redacted]. Simultaneously, [redacted] merged into [redacted], with [redacted] as the surviving legal entity, and [redacted] changed its name to [redacted] (hereinafter "[redacted]"). A Certificate of Merger of "[redacted]" and Change of Name From [redacted] to [redacted] was filed with the State of Delaware, Secretary of State, on [redacted] at [redacted].

At relevant times, [redacted] executed and had three debt instruments or notes outstanding. The first was a $[redacted]% Senior Note due [redacted] with the [redacted]. The second was a $[redacted]% Senior Note due [redacted] with [redacted]. Finally, the third was a $[redacted]% Senior Note due [redacted], also with [redacted].

Pursuant to the underlying terms of each of the senior notes, on [redacted], [redacted] gave irrevocable "Notice" to the lenders, providing an affirmative statement that [redacted] would prepay each of the notes. A prepayment premium was subsequently added to the principal amount of each of the three notes, as a result of the three irrevocable prepayment notices. The calculation of the prepayment premium(s) was based on the Treasury Security rate on the appointed date.

[redacted] filed a short-year federal income tax return for the period [redacted] to [redacted]. On [redacted]'s final short period tax return, it deducted the prepayment premiums as interest expense. [redacted] Sundstrand later paid two of the three notes on [redacted] and the third note was paid on [redacted].

Discussion

Interest paid or accrued within a tax year is deductible for tax purposes under Section 163(a) of the Internal Revenue Code. Prepayment penalties, fees, and premiums are treated as interest for tax purposes because they are an additional fee for using money. See Rev. Rul. 57-198; but see Prudential Ins. Co. of America v. Commissioner, 882 F.2d 832, 837 (3rd Cir. 1989). The prepayment premiums imposed on [redacted] for the early payment of debt are deductible as interest. The issue becomes, as an accrual basis taxpayer, when should these prepayment premiums be accrued and deducted?

Ordinarily, an accrual basis taxpayer is allowed to accrue and deduct an expense when incurred, regardless of when it was actually paid. Illinois Power Co. v. Commissioner, 87 T.C.F. 1417, 1443 (1986). An accrual basis taxpayer must satisfy three requirements to accrue a liability. First, all the events which determine the fact of liability must have occurred. Second, the taxpayer must be able to determined the amount of the liability with reasonable accuracy. Finally, economic performance must have occurred. See Treas. Reg. § 1.461-1(a)(2). Although we believe that all the events which determine the fact of liability occurred in the tax year ended [redacted] and the amount could be determined with reasonable accuracy on [redacted], the prepayment premiums are not deductible in the tax year ended [redacted] because economic performance occurred in the following tax year, when the prepayment premiums were actually paid.

All the events which determine the fact of the liability occurred in the taxable year ended [redacted].

Treas. Reg. § 1.461-1(a)(2) provides that the all events test is met when all the events have occurred which determine the fact of liability. The Supreme Court has stated that, under the all events test, expenses may be deductible before they have become due and payable as long as the liability is firmly established. United States v. General Dynamics Corp., 481 U.S. 239, 246, 107 S. Ct. 1732, 1737 (1987). A taxpayer may not deduct a liability that is contingent on an event. Id.; See also Lucas v. American Code Co., 280 U.S. 445, 452 (1930).

All the events to establish liability probably occurred when [redacted] gave notice of its intent to prepay the loan(s) on [redacted]. The irrevocable notice was a binding agreement for [redacted] to prepay the loan(s). Therefore, the liability was not contingent on any other further events. As a result, the liability became fixed on [redacted], when [redacted] gave notice of its intent to prepay the loan(s).

Your Team Leader, however, argues that the all events test is not met for the year ended [redacted], because the loans were not actually paid until [redacted] and [redacted]. The Team Leader contends that all events that determine the fact of liability occurred when the loans were actually paid off. Since the loans were not paid off until after [redacted], the Team Leader further argues that the all events test was not satisfied for the tax year ending [redacted].

The Team Leader bases his opinion on Revenue Ruling 86-42, 1986-1 C.B. 82, which states that additional interest caused by prepayment on a loan became fixed only when the payment actually occurred and the loan was cancelled. The Service stated that the additional interest upon prepayment of the loan was similar to a prepayment charge "because it is a fee for the use of money that became payable in the year of payment." Rev. Rul. 86-42, 1986-1 C.B. 82. Because the liability in Revenue Ruling 86-42 only became fixed when the additional interest was paid, the Team

Leader believes that [redacted]'s prepayment premiums became fixed when the prepayment premiums were actually paid.

However, Revenue Ruling 86-42 is distinguishable from [redacted]'s facts, because the borrower in Revenue Ruling 86-42 did not give notice of his intent to prepay the loan. Unlike the borrowers in Revenue Ruling 86-42, [redacted] gave irrevocable notice to the lenders that the loans were going to be prepaid, on [redacted]. Because the notice was irrevocable, the notice firmly established the liability for the prepayment premiums on [redacted].

The Team Leader points out that paragraph 4B of the "Note Agreement", states that the prepayment premiums "shall become due and payable on such prepayment date." Because the prepayment premiums only became due when actually paid, the Team Leader contends that the liability was not fixed, by [redacted] giving notice of prepayment of the loan.

Although the loan agreement states that the prepayment premiums become due and payable on the prepayment dates, expenses may be deductible before they have become due and payable as long as the liability is firmly established. General Dynamics Corp., 481 U.S. at 246, 107 S. Ct. at 1737. Merely because the prepayment premiums were not immediately due under the loan agreement does not mean that the prepayment premiums could not be deducted. The prepayment could be deducted, so long as all the events that determine the fact of liability have occurred.

The Team Leader also argues that the notice of the intent to prepay the loan does not fix the liability. To support his position, he cites Pierce Oil Corp. v. Commissioner, 32 B.T.A. 403, 423 (1935), which held that giving notice of an intent to retire debentures does not fix the year for accrual of the resulting loss. However, the notice given in Pierce may be distinguishable from [redacted]'s notice, because nothing in the Pierce opinion states that the notice in Pierce was irrevocable. The Pierce decision is not a good analogy to this case because Pierce involved a loss, not a deduction, and the Pierce decision lacks any discussion regarding when a liability is fixed.

While Pierce may not be a good analogy, the Team Leader does make a good point that the liability may not have been fixed by the intent to prepay "Notice". Although the notice was irrevocable, it is unclear how legally binding the notice was on [redacted] and its successor in interest, [redacted].

Another good point that the Team Leader makes, is that [redacted] did not accrue the prepayment premiums for book purposes. The liability was only accrued for tax purposes, not for book purposes. In [redacted]'s response, [redacted] did not explain why the prepayment premiums were not accrued for book purposes. [redacted] merely cites cases that hold that the substance of a transaction determines its taxability, not how it was recorded for book purposes. While [redacted] is correct that the substance of a transaction controls its taxability, it is suspicious that the prepayment premiums were not recorded for book purposes.

Despite [redacted]'s failure to record the liability for book purposes, we believe that all the events that determine the fact of liability occurred in the tax year ended [redacted]. The liability became fixed on [redacted], when [redacted] gave its irrevocable notice to prepay the loans. The prepayment premiums were not contingent on any further event, beyond the necessity to pay the underlying debt.

Amount of the liability could be determined with reasonable accuracy.

Section 461(h)(4) allows a deduction for a liability when the amount of the liability can be determined with reasonable accuracy. The reasonableness of the estimate is determined by all the facts that were known to the taxpayer at the end of the tax year. A taxpayer is allowed to estimate the amount of a liability when the estimate can be determined with reasonable accuracy. Any discrepancy between the amount estimated and the amount actually accrued, should be corrected in the following tax year. Treas Reg § 1.461-1(a)(2).

The amount of the prepayment premiums could be determined with reasonable accuracy on [redacted]. Although the amount of the prepayment premiums were determined based on the U.S. Treasury Securities rates, the rates of the U.S. Treasury Securities are non-volatile. The rate on the note paid [redacted] years early was [redacted] on [redacted], and [redacted] thirty days later on [redacted]. The rate on the note paid [redacted] years early was [redacted] on [redacted], and [redacted] twenty days later on [redacted]. The rate on the note paid [redacted] years early was [redacted] on [redacted], and [redacted] thirty days later on [redacted]. The rate could easily be predicted, especially because the time period was between twenty and thirty days from the time when the amount was estimated. The actual change in the rate was only [redacted] for two of the loans, and [redacted] for the other loan.

Because the Treasury Securities rates are steady, and because the amount accrued for the prepayment premiums ended up being the actual amount paid, we believe that [redacted] was able to determine the amount of the liability with reasonable accuracy for the tax year ended [redacted].

Economic performance occurs when the prepayment premiums are paid.

"In the case of interest, economic performance occurs as the interest cost economically accrues, in accordance with the principles of relevant provisions of the Code." Treas. Reg. § 1.461-4(e). Although the prepayment premiums are deductible as interest under Section 163, since the imposition of the prepayment premiums are not related to the passage of time, these costs do not economically accrue in the manner described in Treas. Reg. § 1.461-4(e). The position of the Service is that economic performance occurs when the prepayment premiums are actually paid. Therefore, a taxpayer is allowed to deduct prepayment premiums as interest only in the tax year when the prepayment premiums were actually paid.

For example, in P.L.R. 200051035, the taxpayer was forced to pay a prepayment penalty for terminating several financing agreements. The Service found that the prepayment penalty became fixed and the amount of the penalty could be determined with reasonable accuracy on the date when each financing agreement was terminated. However, the Service found that economic performance did not occur until the prepayment penalties were actually paid. Therefore, the taxpayer was allowed to deduct the prepayment penalties only in the year when the prepayment penalties were paid.

Our taxpayer argues that economic performance occurred over the life of the entire loan. The taxpayer points out that no deduction was appropriate earlier, because the all events test was not satisfied since the notice of prepayment did not occur until [redacted]. The taxpayer further contends that the all events test was met when the notice of prepayment was given and at that time, the all events test and economic performance are both met. Therefore, a deduction could now be taken for the tax year ending [redacted], for the prepayment premiums that accrued in the previous years.

However, the taxpayer's argument is not consistent with the Service's position on prepayment premiums/penalties. Although all the events occurred in the tax year ended [redacted], Section 461(h)(1) states that the all events test is not met until economic performance has occurred. Accordingly, the

Service's position remains that economic performance occurs when the prepayment premiums are paid. The economic performance does not occur over the life of the loan, because the prepayment premiums are not related to the passage of time.

The taxpayer may seek to clarify and argue that the prepayment premiums are related to the passage of time, because the agreement uses the amount of time left on the loan to calculate the premium. However, the calculation does not focus on how long the loan was outstanding, the focus is on how much time was left on the loan. This calculation is similar to the calculation in P.L.R. 199951037, where the prepayment penalty was calculated using the net present value of interest payments that would have accrued on the loans had the loan not been paid off early. In P.L.R. 199951037, the Service found that the amount of the prepayment penalty was not related to the passage of time, so economic performance did not occur over the life of the loan. The Service found that economic performance occurred when the prepayment penalty was actually paid. In the present case, since the prepayment premiums did not accrue over the life of the loan, economic performance occurs only when the prepayment premiums were actually paid.

Team Leader's alternative argument is without merit.

In the alternative, the Team Leader argues that if liability was established on [redacted], and the amount can be determined with reasonable accuracy, then only [redacted] of the prepayment premiums would accrue at the tax year ended [redacted]. The remaining [redacted] would have accrued for the benefit of [redacted]'s consolidated tax year (presumably including the calendar period beginning [redacted] and ending December 31, [redacted].

We do not believe that this is an acceptable way to accrue the liability for the prepayment premiums. There is no authority to support this position. The Service's position is that economic performance occurs when the prepayment premiums are actually paid. The amount of the prepayment premium(s) is not related to the 30 day grace period, so it should not be accrued ratably over that same 30 day period.

Conclusion

Because economic performance for prepayment premiums does not occur until the prepayment premiums are actually paid, [redacted] is unable to properly claim a deduction for the prepayment premiums in the short period tax year ending [redacted].

Should you have any questions regarding this memorandum or the advice contained herein, please contact the undersigned at (312) 886-9225, Extension 319.

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